# Fiscal policy in the European Economic and Monetary Union

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*Chapter 6*

# Concluding remarks

This thesis is about fiscal policy in Europe's Economic and Monetary Union. The aim is to shed light on two issues. In the first place, what are the effects of the EU's fiscal governance system on the fiscal policy of EMU member states? Do fiscal rules affect projected fiscal policy, actual fiscal policy, neither of them or both? Secondly, how did fiscal policy in EMU member states impact economically, in particular in the light of substantial fiscal adjustment carried out in the deepest economic crisis in decades?

Answers to these questions are provided in the various chapters of this thesis. Chapters 2 and 3 highlight that, for EMU member states, fiscal rules both affect fiscal forecasts and actual fiscal adjustment. The bias in forecasts seems to be attenuated by the presence of independent fiscal councils at the national level. Chapter 4 shows that, for the Netherlands, news messages suggesting an increase in the likelihood of fiscal consolidation, increase investors' confidence in the solvency of the Dutch government. Chapter 5, finally, finds that despite the substantial decrease in public investments in European countries in response to the crises, the effect of public capital shocks on economic growth has not increased in general, although results differ markedly between countries.

From these findings, a rather positive picture emerges on the SGP, in the sense that the Pact seems to achieve what it is intended for. Although creating incentives for fiscal gimmickry, fiscal rules do seem to discipline countries and thus, despite fears of self-defeating austerity, to improve fiscal sustainability.

Accepting the underlying rationale of the SGP as it is, this does not mean there is no room for improvement. The SGP is not only meant to correct excessive deficits as they occur, but also to prevent them in the first place, or at least to limit their magnitude. This is arranged in the preventive arm of the SGP. In short, the preventive arm sets a minimum required improvement in the structural budget balance and a maximum allowed (corrected) expenditure growth for countries whose structural budget balance is still below its country-specific Medium Term Objective (MTO). With an effective preventive arm, less fiscal adjustment is needed when this is most procyclical and therefore economically painful.

The preventive arm seems rather weak, though. In the years leading up to the crisis, the preventive arm did not convincingly manage to move countries towards budgets close to balance or in surplus. In 2007, in a generally buoyant economic environment, only ten out of 27 EU countries had achieved or were foreseen to achieve their MTO within the next year (EC, 2007). More recently, after substantial amendments have been made to the SGP aimed at improving the functioning of the SGP, compliance is still poor (European Court of Auditors, 2018).

The question now is whether the preventive arm could be designed in such a way that it obtains more of the disciplining power the corrective arm currently has. A number of suggestions for improvement de facto go in this direction. For example, rules could be simplified, the room for use of flexibility clauses could be constrained, and sanctions could be aligned more with those applicable in the corrective arm. To obtain a better understanding of which element of the corrective arm underpins its effectiveness - and thus to be able to provide more specific suggestions for enhancing the preventive arm - more research into the different elements of the corrective arm is needed.

A second potential improvement concerns the debt criterion. A prominent goal of the SGP is to prevent countries from running unsustainable fiscal policy. In this vein, the EDP can in principle be opened on the basis of a deficit exceeding 3% of GDP, or a gross debt level exceeding 60% of GDP and not declining fast enough. While this debt threshold is in nature more closely linked to concepts of fiscal sustainability than the deficit threshold, in practice an EDP has never been opened on the basis of the debt criterion alone.

In recent years, countries that *prima facie* did not comply with the debt criterion, still did not face a launching of the EDP. Arguments put forward by the EC were e.g. that “there is currently not sufficiently robust evidence to conclude on the existence of a significant deviation”, that there was “some progress in adopting and implementing growth enhancing structural reforms”, or that the country was in “broad compliance with the adjustment path towards the MTO, once taken into account the granted allowance for unusual events”.

Perhaps a relatively simple solution would be to take all these relevant factors into account not when deciding whether to launch an EDP or not, but when deciding how much fiscal adjustment a country has to deliver. The opening of an EDP could be applied more mechanically. In this way, at the very least the ‘forcing’ eyes of the EDP would be put to work more often.

Of course, the global financial crisis and the European debt crisis taught us that just having an effective set of fiscal rules would probably not have prevented the steep drop in GDP and the ensuing procyclical fiscal adjustment. After all, crisis-struck countries Spain and Ireland actually had reached their MTO in 2007. The set-up of the EMU allowed for the build-up of large macro-economic imbalances, and the close connectedness between banks and sovereigns caused great fiscal problems once these imbalances unwound.

Over the last few years, a large part of the missing institutional set-up in the euro area has been put in place. For example, the banking union was created to reduce the national sovereign-bank nexus, and the European Stability Mechanism is there to help euro area countries in severe financial distress.

But is it enough? By fixing exchange rates, countries gave up an important macro-economic adjustment mechanism. With adjustment via real prices being very painful and given low labor mobility in Europe, other mechanisms are sought after to facilitate adjustment. Two lines of thinking regularly voiced are enhanced private risk sharing, via a deepening of the capital market union, or more public risk sharing, for instance via a central fiscal capacity. Progress along either of these lines while maintaining public and political support of all member states will be challenging. If European countries succeed, the interconnectedness between European economies is likely to increase as they both entail more integration, either economic or political, among the members of the euro area, exactly as envisaged by Robert Schuman back in 1950.